Implications of the State of the Dairy Economy[1]

Two major phenomena describe the state of the dairy economy in this nation today. These phenomena are --

1. A substantial excess of milk production over commercial demand at established price levels. Furthermore, the problem is not getting resolved; production and surpluses have been and are increasing.

2. Some general disarray in the producer sector in getting to an acceptable price support solution that Congress and the Administration would find credible in terms of reducing milk surpluses and program costs.

At this juncture, everything else in the dairy economy has become secondary. My intention is to dwell more on the state of the dairy economy, and less on the implications of the situation.

First, a statement of fact: when national milk supplies exceed market needs by four percent or more on an annual basis, then the level of producer milk prices and income is affected almost exclusively by provisions of the price support program. That is why price support discussion commands the dairy arena at the present time. Let me trot out some of the standard measures of the dairy outlook so that we can have some kind of a common base.

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[1]Robert E. Jacobson, Professor, Agricultural Economics, for presentation at the 38th Annual Midwest Milk Marketing Conference Madison, Wisconsin, March 8, 1983.

1. So far, with respect to producer milk prices, we have not yet seen any pain -- we have only seen the expectation of pain. Blend prices in Grade A markets and manufacturing milk prices in B markets (a) continue to look quite healthy relative to the rest of agriculture, and (b) continue to hold very well in comparison to last year's prices. January, 1983 blend prices in 45 Federal order markets averaged $13.63 per cwt., up by one cent from January, 1982. The January, 1983 M-W price of $12.62 was up 17 cents from a year ago, but down 2 cents from two years ago. The fact that we have not seen pain yet does not diminish the problem. We know absolutely that economic discipline will be coming to the milk producer sector.

2. The quickest way to zero in on the milk surplus problem in the United States is to look at the recent trends in milk production, commercial demand, and CCC purchases. Since our national dairy herd began rebuilding in cow numbers in mid-1979, we can select 1979 as a starting point.

	U.S. Milk Production	Commercial Demand	CCC Purchases
1979	123.4 Bil. Lbs.	120.2 Bil. Lbs.	2.1 Bil. Lbs. m.e.
1980	128.4	119.2	8.8
1981	132.6	120.1	12.9
1982	135.8	122.0	14.3
1983	(138.0)	(123.0)	(15.0)

The data essentially tell us that milk production has been walking away from aggregate demand in this past four years. CCC has been picking up the difference, and that now means a surplus equivalent to more than 10 percent of production.

The situation in 1983 and 1984 promises to worsen unless meaningful changes can be made quickly in the dairy price support program.

Several quick observations should be made about the dairy outlook:

A. The 2.4 percent production increase from 1981 to 1982 shows little sign of abating. Production in January, 1983 was up 1.6 percent from January, 1982. Cow numbers were up again in January, 1983, at 11,055,000 milk cows in the national dairy herd. That is 350,000 more cows than the mid-1979 estimate. We may be at the peak of the cycle, but we may not.

B. The ratio of replacement heifers 500 pounds and over per 100 milk cows stood at a record 43.5 on July 1, 1982. For the entire 1965-1975 decade, this ratio was only 32-33 heifers. The slight decline in the ratio on January 1, 1983 to 41.0 was mostly a seasonal factor, and a huge reservoir of dairy animals is getting ready for production.

The price of milk cows for replacement purposes dropped to $1,050 in January, 1983. That's down 15 percent from the record $1,240 reported for January, 1981. The drop in price may be a measure of producer milk price expectations for the future, but it is also a measure of the large supply of dairy animals available for production.

C. Key factors we generally look to in projecting milk production, other than the milk price itself, are feed prices (costs) and beef prices. The USDA cost of production studies have shown feed costs to be holding steady at very close to 50 percent of the total direct and ownership costs of producing milk in the 1979-1981 period. The milk-feed price ratio has been increasing since mid-1981 and has been at a very healthy 1.6 level this winter. It is certain to decline as we look ahead -- milk prices will weaken, and the PIK program at some point will achieve its price purposes -- but it has quite a way to tumble, such as 1.3 and below, before milk production begins to be squeezed out due to feed costs. That will not happen in 1983.

It's easy to observe that if we have 10 percent too much milk, we have 10 percent, or 1 million plus, surplus milk cows. Cow culling rates are influenced by beef prices, and beef prices have not been any help to the milk industry more recently. Utility cow prices averaged 50 cents a pound in 1979, 46 cents in 1980, 42 cents in 1981, and just under 40 cents in 1982. At the present time, it's difficult for a milk producer to get much more than 40 cents a pound for cull cows. While beef prices are expected to increase by 5-8 cents this spring, there is nothing in the 1-2 year outlook that suggests the kind of price strength required to encourage culling.

Other factors can be introduced, but the point is made. There is a substantial excess of milk production overdemand; variables affecting production are in a plus phase, and only significant changes in the price support program can shift the industry back toward balance.

D. Production is the problem -- not demand, but demand should be recognized. When we talk about demand, we are talking about domestic demand. The pressure to expand exports may be increasing, but we have severe limits on any significant commercial export demand.

The main point to recognize about domestic commercial demand is that it's doing fine. Consider the following per capita consumption data.

Table 1. Per Capita Milk Consumption, U.S., 1970 - 1982

	Commercial Sources	All Sources
1970	511 Lbs. m.e.	561 Lbs. m.e.
1975	506	540
1980	509	544
1981	517	541
1982	521	560

Source: December, 1982 Dairy Situation, ERS-USDA, p. 18.

The data in Table 1 basically say that per capita consumption across all milk products has changed very little in this past dozen years. Aggregate demand has increased with population increases. This does not mean to relax the guard. If NMPF can get its 15 cent per cwt. mandatory promotion assessment legislated, fine. But it is not a weakening of demand that is at the core of today's dairy problem. Also, intensified efforts to promote demand are appropriate, but if generic promotion by itself can expand demand by as much as 1 percent, it will have made a major accomplishment.

3. Price -- The present support price of $12.80 has been constant now for 2 1/2 years. It was 80 percent of parity when it was implemented on October 1, 1980 -- today it is 65 percent of parity. The M-W price averaged $12.48 per cwt. in 1982 --

32 cents under the support price. The M-W price has rested completely in the range of $12.42 to $12.67 now for 29 consecutive months -- talk about stability. The outlook on this ultimate barometer of milk prices is exclusively tied to the price support program. The Omnibus Budget Reconciliation Act of 1982 promises the $12.80/$13.10 support price through September 30, 1984, with a modest parity adjustment for 1984-85. But we have already seen the dairy title of the Agriculture and Food Act of 1981 disintegrate, and the flow of milk production promises a similar interruption to the 1982 Act.

<u>The Options</u> -- At the moment, the milk industry is caught up in three support options. These are (1) Mr. Block's one dollar assessment, (2) new authority to simply lower the support price by authorized amounts, and (3) some version of a proposed voluntary base-quota plan, with incentives to reduce production and maybe penalties on increasing production. The most common thread among the three alternatives is simply a recognition that there is surplus milk and something has to be done about it.

1. <u>The $1 Assessment</u> -- Even today, three weeks from implementation, we do not know if the $1.00 assessment to be implemented April 1 is going to float. After all, we did not know that the first 50 cent assessment implemented last December 1 was not going to float until more than three weeks <u>after</u> it was implemented.

The most redeeming feature of the $1.00 per cwt. assessment on all milk marketed is the certainty that it will make a large cut in CCC net expenditures for dairy price support. Its primary minuses include (1) its limited impact on milk production, (2) the nebulous aspects of recouping the second 50 cents, and (3) the indiscriminate manner in which all milk producers are assessed. Enough said -- we'll have to wait and see whether it lives or dies, probably in the Federal courts.

2. Drop In Support Price -- In early May, 1982, Secretary Block requested 'discretionary authority' to drop the support price. He has not been given that authority. Congress would have to authorize it. But we continue to hear noises about that possibility. Most recently (Feb. 10), the Congressional Budget Office outlined a plan that would drop the support price by 50 cents every six months until the total cut amounted to $2.50. The main possibility for a lower support price emerging is if the other options don't survive, i.e., neither the assessment nor a quota plan will be viable. The main arguments for a drop in the support price include simplicity (look to the market), and some potential demand stimulation. Main arguments against dropping the support price are (1) that all milk producers would be affected, and individual producers could not find incentives to cut back output and still have price security, and (2) more time and more patience than are reasonable to expect would be required to achieve supply-demand balance. But lower support prices will happen if something else doesn't happen.

3. Base-Quota Plan -- Lack of agreement on getting to some

kind of a base-quota plan is the most visible symptom of the different interest positions across the milk producer sector nationally. While the Administration is probably negative on most base-quota proposals, it is lack of consensus in the producer sector that has proved initially to be the most formidable hurdle. The Wisconsin politicos have advanced the Dairy Surplus Production Act, with its $10 payments for milk not produced. It is purely voluntary. The NMPF advanced its Dairy Compliance Act, with its voluntary incentives to cut back and its mandatory dis-incentives to expand. Other versions and cross-breeds are sure to follow, and there is the (remote) possibility that a program could be legislated. Main arguments for a base-quota plan are (1) that it could offer a quicker route to reducing production and surpluses, and (2) it permits every producer to have more of a say about his own economic destiny as he makes production decisions. Main arguments against a base-quota plan, assuming that base capitalization possibilities are diminished, are (1) a messy bureaucracy would be required to operate the program, (2) once it's there, it's tough to get rid of, and (3) no price possibilities would exist to stimulate demand.

So there we have it -- three program avenues in front of us, and no inclination to be persuaded that any one of them is in front of the other two. But one of the three will have to prevail. Without a program change, CCC will continue to acquire product at the $12.80/$13.10 support price. With milk production continuing to increase, the financial back of the price support program would be broken. CCC net expenditures for dairy price support for the 1980-81 marketing year were $1.97 billion and were $2.23 billion in 1981-82. In the first five months of this current marketing year, CCC purchases are running 24 percent larger than in 1981-82. There has to be a change.

Implications: Regardless of the program changes that come along, some major implications of the present situation can be identified. Let's see what one list of these might look like.

1. Any new program had better work. The biggest threat -- the largest fear -- has to be that a new dairy program will not work, or it will not work quick enough. For example, what if a Dairy Surplus Reduction Act would mean even more milk and more CCC purchases two years from now? It's that scenario that threatens the existence of any kind of a dairy program.

2. Parity is probably gone forever as a price target concept for milk. The Agriculture and Food Act of 1981 pushed parity to the sidelines. The Omnibus Budget Reconciliation Act of 1982 basically confirmed that push. Today we see milk prices at 65 percent of parity, but corn prices are 46 percent of parity, soybean prices are 43 percent of parity, and beef prices are 57 percent of parity. Some new price standard for dairy price support is going to have to be lifted up. It's time the industry addressed itself to long run policy determinations

rather than short run emergency solutions.

3. The dairy farm structure in the United States will continue to concentrate. That is not news. But what about the kinds of effects on structure in the squeeze ahead of us? The number of farms with milk cows in the U.S. dropped from 322,850 in 1981 to 311,800 in 1982 (minus -3.4 percent). That only extends the long term trend. The number of commercial dairy farms in the U.S. is only about 60 percent of the number of all farms with milk cows. I doubt that the squeeze will hasten the trend toward larger dairy farms any faster than has been occurring. Many relatively small dairy farmers are in a low debt-high equity position and can weather tighter economic times. There will be an adverse impact, though, on entry by new, younger dairy farmers, especially if we go a base plan route where base acquisition is made difficult.

4. Regionalism has emerged. Two to three decades of relative harmony have described the producer sector nationally. The old midwest-northeast conflict disappeared. We have accepted a national dairy price support program with a single national dairy support price. But now we have a national problem, and different regions have contributed in different proportions to the problem. Therefore, regional differences! The South Carolina challenge to the 50 cent assessment illustrates a regional reaction. Regionalism was quiet when we did not have excessive surpluses; an answer to regaining national unity is to be rid of those surpluses. We will hear more about regionalism

in the next presentation when differences in regional milk production costs are evaluated.

5. Dairy cooperatives are under a larger burden than ever. In the process of guaranteeing member producers a market, dairy coops are handling most of the surplus milk in the United States. Now we have more surplus than ever. The spring flush is right in front of us. Distress prices for surplus milk will prevail. High freight costs will occur on milk moving long distances just to find an outlet. Coops will find it difficult to meet minimum Federal order blend prices. Some handlers will exploit the situation by nurturing more non-members. Changes in the CCC purchase program have their direct immediate effect on cooperatives because that is where most of the product is found. As milk prices weaken, members will get increasingly critical of coop assessments. And the problems go on and on.

How do you turn those kinds of problems into opportunities? There may be no reasonable answer. But dairy cooperatives should not forget that in most markets, they are the dominant marketing institution. Cooperatives have the processing/ manufacturing capacity. And whether it's producers looking for a market, or handlers looking for milk, dairy coops are front and center. Operations and policies may have to be adjusted, but surplus milk can mean more opportunities for expanding market influence.

6. Maybe there are some marketing lessons for us in this period of stress. And maybe we should be considering those lessons. The crutch of an open-ended CCC purchase program has

drained a lot of marketing vitality from the industry over this past three decades. What are some of the lessons?

a. In the long run, we cannot produce milk in isolation from demand. Producer milk prices will have to be established accordingly. The temptations politically, in the late 1970's, to push for higher percentages of parity ignored demand. That is a short run luxury, but a long run cost, and today we are looking at the costs.

b. If demand is that important, what can we do to massage demand? How can we shift our thinking from <u>pricing</u> milk to <u>marketing</u> milk and dairy products? What can we do on domestic demand? Do dairy exports hold any significant potentials? Yes, there are some kinds of answers to these questions. Product promotion and broader financial support for it is always a first answer. New products such as UHT need to be researched, developed, promoted, and marketed.

The export market for dairy products needs additional investigation. I'm not talking about dumping surplus dairy products on a donation or subsidized basis. That's not marketing -- that's just hiding the problem. We'll always have major problems finding commercial export outlets for dairy products, but if we could add 1 billion pounds milk equivalent a year in the form of some special products to our exports, that would be a real boost.

7. <u>A continuing implication concerns how we support the price of milk</u>. By resting the entire national milk price structure on CCC purchase prices for butter, cheese, and nonfat

dry milk, we take away all possibilities for effectively competing in the marketplace for sales of these products. With powder at 94 cents a pound, 70 percent of NFDM production goes to the government. With butter at $1.50, 31 percent goes to the government. In 1960, per capita consumption of nonfat dry milk was 6.3 pounds; today it is 2.7 pounds. Butter was 7.5 pounds; today it is 4.3 pounds. Fortunately, cheese has not been hit -- yet. Isn't there an implication here that if we want to support milk prices, and if we want to market dairy products, then it's time we got serious about some alternatives -- some alternatives that don't kill demand.

8. A final implication has to do with bad publicity. The costs of the price support program, the visibility of inventories as demonstrated in the butter and cheese giveaways, and the continuing responsibility of Congress to meet requirements of the Budget Control Act of 1974 basically means a lot of negative publicity for the milk industry in 1983. The problems cannot be denied, but hopefully we can use this period as a "teachable moment," for ourselves and for the public. The price support program exists for solid reasons, and everyone of us has a responsibility to communicate those reasons.

Those are some of the implications of the dairy economy today. Many more should emerge through the remainder of this Conference.